INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Argument	5
Conclusion	7

CITATIONS

Cases:

Harwood v. *Eaton*, 68 F. (2d) 12, certiorari denied, 292 U. S. 636 — 6

United States v. *Joliet & Chicago R. Co.*, 315 U. S. 44 — 5, 6, 7

United States v. *Warren R. Co.*, 127 F. (2d) 134 — 6, 7

Statute:

Internal Revenue Code:

Section 3710 (26 U. S. C. sec. 3710) — 2

548989—43

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 228

THE MORRIS AND ESSEX RAILROAD COMPANY, CORA DREYFUS, LILLIAN A. NEUBERT AND LAURA D. PEPPER, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 49–51) is not reported. The opinion of the Circuit Court of Appeals (R. 61–65) is reported in 135 F. (2d) 711.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 24, 1943 (R. 65–66). The petition for a writ of certiorari was filed August 5,

1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

The taxpayer leased all of its properties to another corporation for the duration of the lessor's corporate charter. The lease provided for the payment of stated dividends by the lessee directly to the stockholders of the taxpayer. The Commissioner of Internal Revenue assessed income taxes for the years 1933–1941, inclusive, against the taxpayer in respect of its taxable net income consisting of the payments to the stockholders, but the assessments (except the original tax for 1933) have not been paid. Was it error for the District Court to grant a preliminary injunction enjoining the lessee from paying further rental dividends to the stockholders until the Collector could levy thereon for the purpose of effecting collection of the unpaid assessments?

STATUTE INVOLVED

Internal Revenue Code (26 U. S. C., sec. 3710):

> SEC. 3710. SURRENDER OF PROPERTY SUBJECT TO DISTRAINT.
>
> (a) *Requirement.*—Any person in possession of property, or rights to property, subject to distraint, upon which a levy has been made, shall, upon demand by the collector or deputy collector making such levy, surrender such property or rights to such

collector or deputy, unless such property or right is, at the time of such demand, subject to an attachment or execution under any judicial process.

* * * * *

STATEMENT

In 1868, the Morris and Essex Railroad Company, a New Jersey corporation, the taxpayer petitioner,[1] leased all of its properties to the Delaware, Lackawanna and Western Railroad Company, a Pennsylvania corporation, for the full term of the continuance of the lessor's corporate charter and any renewals thereof, conditioned upon payment by the lessee of interest upon the lessor's bonds and capital stock (R. 17–29). The original lease provided that the "interest" upon the capital stock would be 7% per annum, payable semi-annually directly to the stockholders (R. 21). In 1917, the lease was amended to provide for payment of dividends upon the lessor's capital stock at the rate of 7¾% per annum, 4¼% payable on January 1 and 3½% on July 1 (R. 34). The portion of the lease providing for the payment of dividends was printed on the back of the stock certificates (R. 39). The lessee promised to pay any income taxes "on the income or profits of the said business" (R. 20).

The instant action was brought against the taxpayer and the lessee for the purpose of effect-

[1] The other petitioners are intervening shareholders of the taxpayer corporation (R. 62).

ing collection of delinquent income taxes assessed against the taxpayer for the years 1933–1941, inclusive, such claims aggregating $2,114,084.60, with interest, or alternatively, in the event the lessee was not obligated to pay the lessor's income taxes, $1,751,940.96, with interest (R. 8–17). Among the prayers of the complaint was one asking that the lessee be restrained from paying rental dividends to the stockholders of the lessor railroad until the Collector could levy thereon for the purpose of satisfying the Government's tax claims (R. 16). Another prayer asked that the lessee be ordered to pay to the Collector upon demand the rental dividends (R. 16–17). The complaint asserted that by reason of the assignment and conveyance of the taxpayer's properties to the lessee pursuant to the terms of the lease between the parties, the taxpayer was insolvent and without assets or properties against which the Government could institute proceedings to effect the collection of its claims (R. 14).

In opposition to the Government's motion for the preliminary injunction, counsel for the taxpayer filed an affidavit which does not deny that the taxes assessed by the Commissioner are due and owing as alleged in the complaint (R. 32–37). Likewise, the affidavit of petitioner Cora Dreyfus, one of the taxpayer's shareholders, fails to challenge the taxpayer's liability for the assessments (R. 46–48). The affidavit of the Assistant United

States Attorney supporting the motion for the preliminary injunction asserted that if the lessee were permitted to carry out its intention of paying the dividends due on January 1, 1943, to the stockholders of the lessor, the only asset of the lessor from which the income taxes could readily be satisfied would be diverted and such payment and diversion would work an immediate serious and irreparable damage and injury to the plaintiff (R. 6–7).

The District Court granted the injunction (R. 49–55), and the Circuit Court of Appeals affirmed (R. 65–66).

ARGUMENT

The taxpayer had leased all its properties and the lessee agreed to pay rent in the form of dividends or "interest" to the taxpayer's stockholders. Such payments constitute taxable income to the taxpayer (*United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44). However, since the taxpayer had no other free assets out of which the taxes could be paid, it was entirely appropriate for the District Court, in the exercise of its equity powers, to enjoin the diversion of those rental payments to the taxpayer's stockholders until the tax liability is satisfied.

The petition erroneously assumes (Pet. 11) that the funds sought to be reached have already become the property of the stockholders. Both the Government and the stockholders are claimants of

the funds. The Government has a claim against the lessor-taxpayer and the latter has agreed that the rental income which would otherwise be received by it, and thus be available to satisfy the demands of the Collector, shall be paid directly to the stockholders. The lessee proposes to pay this rental income to the stockholders, and the question is whether the Government may intervene and prevent the payment. The taxpayer has no funds to satisfy the tax claim (R. 54), and if the payment is not enjoined the Government may be without a remedy. Cf. *United States* v. *Warren R. Co.*, 127 F. (2d) 134 (C. C. A. 2); *Harwood* v. *Eaton*, 68 F. (2d) 12 (C. C. A. 2), certiorari denied, 292 U. S. 636. The District Court found that taxes are due the United States in excess of the annual rents payable and that the injunction is necessary to prevent irreparable injury (R. 53–54).

The rental income involved is that of the lessor-taxpayer and the rights of the stockholders are purely derivative. *United States* v. *Joliet & Chicago R. Co., supra.* Petitioners assume that, by action which is in effect the declaration of dividends in the amount of its entire income, a corporation can create rights in the stockholders superior to the tax claims of the Government (Pet. 9–12). This view is not supported by any authority and is clearly without merit.

Petitioners' argument that the stockholders have vested rights as against the United States is predicated (1) upon decisions of the New York and New Jersey courts that the stockholders have such rights as against the corporation, and (2) upon the assumption that the stockholders do not take the payments through the lessor (Pet. 10). However, this theory is squarely opposed to the decision in the *Joliet & Chicago R. Co.* case.

Accordingly, the stockholders stand here as mere claimants, competing with the United States for funds in the possession of a third party. Where the funds belong to a taxpayer it is the declared policy of Congress that the United States is entitled to possession as against other claimants (Section 3710 of the Internal Revenue Code, *supra,* pp. 2–3). The decision that the payment to the stockholders should be enjoined is in harmony with that policy. *United States* v. *Warren R. Co.,* 127 F. (2d) 134 (C. C. A. 2).

CONCLUSION

The decision below is correct, and no conflict of decisions or question of general importance is

involved. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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SEPTEMBER 1943.

End

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